INDEX

TESTIMONY OF

ALLEN L. BURNS, SYDNEY D. BERWAGER, AND MICHAEL J. DEWOLF

Witnesses for Bonneville Power Administration

SUBJECT: Policy

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Section 1. Introduction and Purpose of Testimony

Q. Please state your names and qualifications.

A. My name is Allen L. Burns. My qualifications are contained in WP-02-Q-BPA-08.

A. My name is Sydney D. Berwager. My qualifications are contained in WP-02-Q-BPA-03.

A. My name is Michael J. DeWolf. My qualifications are contained in WP-02-Q-BPA-16.

Q. Have you previously filed testimony in the WP-02 proceeding?

A. Yes.

Q. What is the purpose of your testimony?

A. The purpose of this testimony is to generally describe changes occurring since our Amended Proposal to the 2002 Power Rate Case (Amended Proposal), in particular, substantially higher and more uncertain market prices and a decline in the expected value of starting reserves for Fiscal Year (FY) 2002. We then summarize some fundamental design changes to our Amended Proposal for Load-Based (LB), Financial-Based (FB), and Safety-Net (SN) Cost Recovery Adjustment Clause (CRAC) mechanisms and to the Dividend Distribution Clause (DDC). These changes are a result of settlement discussions with rate case parties. Although these discussion did not yield a settlement with all parties, the discussions did resolve most issues with all the investor-owned utilities (IOUs) and state commissions (PUCs) as well as virtually all of the rate case parties that represent nearly all of the region's individual public utilities. The design changes to the CRACs and DDC and other solutions that are part of the Partial Settlement Agreement (s*ee* Attachment A) are different enough from Bonneville Power

Administration's (BPA) Amended Proposal to warrant this Supplemental Power Rate Proposal (Supplemental Proposal). This testimony provides an overview of the Supplemental Proposal and supporting policy decisions made to support this proposal.

Q. How is your testimony organized?

A. This testimony is organized in four sections. The first section is this introduction. Section 2 describes the need for this Supplemental Proposal. Section 3 explains the policy objectives of the Supplemental Proposal. Finally, Section 4 summarizes the major changes in this Supplemental Proposal.

Section 2. Need for the Supplemental Proposal

Q. Please describe why BPA has decided to file this Supplemental Proposal.

A. There are three reasons why BPA is filing this Supplemental Proposal. First, BPA's forecast for starting rate period reserves has dropped very substantially since the forecast in our Amended Proposal. Second, market prices available now for power during the first two years of the rate period are significantly higher than BPA had forecast in the Amended Proposal. Regardless, BPA would have prepared an update to the Amended Proposal to show the impact of these revised forecasts on BPA's proposed rates. The third reason is that, as a result of discussions with the rate case parties, BPA reached a Partial Settlement Agreement with many of those parties. Part of that agreement is that BPA will file a Supplemental Proposal reflecting the Partial Settlement Agreement.

Q. Please describe the changes that have occurred in BPA's financial situation since BPA filed its Amended Proposal in December.

A. Since December, forecasts for run-off for this water year have declined substantially. Water Year forecasts in our 2002 Final Power Rate Proposal (May Proposal) and Amended Proposal assumed average water for both this FY 2001 and for the next five years of the rate period – 102.4 million acre feet (MAF). By contrast, this year could be the fourth lowest runoff year on record, with current runoff forecasts now at 67 MAF.

These conditions are requiring BPA to purchase much more power this year than expected to meet loads, at extremely high prices, and have reduced the amount of surplus energy BPA can sell this year. As we described in our Amended Proposal, prices in the wholesale electricity market have been extremely volatile and high. BPA has seen these increased market prices during this year. In fact, during one week in January alone, BPA purchased over $50 million in power to meet load. This is putting tremendous pressure on our end-of-year reserves. End-of-year reserves translate into starting rate period reserves. In our May Proposal, starting reserves were estimated to be $842 million on an expected value basis. In our Amended Proposal, our starting reserves expected value estimate had increased to $929 million. Now, the expected value of BPA's starting reserves estimate has dropped to $309 million. There is still a significant range of uncertainty surrounding this estimation of starting reserves. This is driven by some unknown factors for the rest of this fiscal year around hydro operations related to fish requirements, run-off levels, and the volatility in market prices. BPA will update the starting reserve level in the final studies based upon the results of the second quarter review. It should be noted that the new estimates of starting reserves from the First Quarter Review of FY 2001 may differ somewhat from the estimates used in this Supplemental Proposal due in large part to the difference in timing for the two studies.

Q. How does this drop in starting reserves affect BPA's rates and cost-recovery adjustment charges?

A. Starting reserves are a key risk mitigation tool in this rate proposal. (*See* Lefler, *et al.*, WP-02-E-BPA-73.) A significant drop in starting reserve levels, without other adjustments, reduces Treasury Payment Probability (TPP) for the five-year rate period. Therefore, in order to offset this decline, and maintain a TPP level within the acceptable range, adjustments to other tools need to be made.

Q. Besides the increase in market prices for power in the past few months, are there other changes to market prices that BPA has noticed?

A. Yes. Market prices during the rate period are higher in the first years of the rate period, ranging from $200/megawatthour (MWh) to $240/MWh for FY 2002, and then drop during the last years of the rate period, to a range between $40/MWh and $60/MWh in FY 2006. This compares with a risk-adjusted expected price forecast in the Amended Proposal for the five-year rate period around $48/MWh, where expected prices for individual years did not vary by more than $5/MWh from the $48/MWh average.

Q. Please explain how this affects BPA.

A. Because BPA will be in the market purchasing power to serve load during the next five years, BPA's purchase power costs will fluctuate as market prices change. Because the potential levels of power purchases and prices are so great, BPA needs to concern itself not only with annual or rate period totals, but with the seasonal and semi-annual timing of costs and revenues. In order to maintain TPP at an allowable level, all other things being equal, the expected value for the average rate over the five years will be higher with an average flat rate than with a rate shaped to match the expected market. Therefore, BPA has revised the LB CRAC so that our expected revenues closely match the shape of our augmentation costs.

Q. BPA has participated in settlement talks with the rate case parties. What has been the result of these discussions?

A. BPA staff held productive discussions with rate case parties to explain the changes to starting reserves and market price escalation and uncertainty that have occurred since the Amended Proposal and that must be addressed in this rate case. BPA and a large group of the parties were able to reach agreement on how BPA should address these problems. The Partial Settlement Agreement, shown in Attachment A, embodied concepts that are different from what is contained in BPA's Amended Proposal. This Supplemental

Proposal represents a package that meets BPA's critical objectives as specified in the Amended Proposal and resolves most of the issues that rate case parties had with BPA's earlier proposal. By preparing this Supplemental Proposal, along with presenting the Partial Settlement Agreement, BPA can give rate case parties an indication of the effects of the lower starting reserves and higher market prices.

Q. What is the general design of this Partial Settlement Agreement?

A. The Partial Settlement Agreement is intended to serve as a basic understanding for an acceptable approach to resolving the cost recovery problem faced by BPA. The Supplemental Proposal is intended to serve as a means of implementing the objectives and intent outlined in the Partial Settlement Agreement. The Partial Settlement Agreement acknowledges that BPA staff would not use the exact language of the Exhibit A of the Partial Settlement Agreement when it developed this Supplemental Proposal. Time and other factors did not allow BPA staff and the parties to develop the Partial Settlement Agreement with the same detail as is embodied in the Supplemental Proposal. This level of detail is necessary to include, for example, in the General Rate Schedule Provisions. In the testimony of Lefler, *et al*., WP-02-BPA-E-73, BPA staff describe how they embodied the intent of the Partial Settlement Agreement in specific language.

Section 3. Policy Objectives of the Supplemental Proposal

Q. What policy objectives drove the Amended Proposal?

A. We described in our December testimony supporting the Amended Proposal, the development of our policy objectives. (*See* Burns, *et al*., WP-02-E-BPA-62, at 4.) They are restated here.

In BPA's August 31, 2000, letter to customers and interested parties, the BPA Administrator described the criteria BPA used to determine the appropriate approach to solving this cost-recovery problem. The criteria for the proposed solution were:

1. It should be as simple as possible;
2. It should allow Subscription contract signing to proceed to completion as soon as possible;
3. It should not require review or revision of the overall Subscription Strategy;
4. Specifically, reallocation of Subscription power among customer groups, or a change in the basic balance of interests in Subscription should not be required;
5. It should require limited revisions, if any, to the 2002 rate proposal currently before Federal Energy Regulatory Commission (FERC), and limited revisions, if any, to the Subscription contract; and
6. It must achieve the goal of leaving BPA's probability of repaying the U.S. Treasury, in full and on time, within an acceptable range over the 2002-2006 rate period.

Q. What was the guidance you gave to staff redesigning the CRAC for the Amended Proposal?

A. First, the CRAC, when combined with the other risk mitigation tools that are being modeled, should achieve a TPP that falls within the 80 to 88 percent range established by the Fish and Wildlife Funding Principles (Principles), specifically Principle No. 3.

Second, redesign of the CRAC should satisfy Principle No. 4.

Third, given that revenue requirements are not being revised, the CRAC, along with commensurate changes in the Slice, must remedy the under-recovery that results from the likelihood of purchasing more power at higher prices than assumed in the May Proposal.

Fourth, all other things being equal, BPA would prefer to utilize contingent measures to mitigate revenue and cost uncertainties because the expected value cost to ratepayers is lower. However, this must be balanced with tools that will avoid rate shocks resulting from frequent and significant changes to rates, potential customer problems of liquidity, and other implementation risks not captured in the risk analysis.

And finally, BPA sought to minimize the potential for contention and administrative burden during implementation of the CRAC. *See* Burns, *et al.*, WP-02-E-BPA-62, at 5.

Q. Has this guidance changed?

A. The guidance has been refined based on the nature of the Partial Settlement Agreement. We would still like to avoid rate shock, including the desire for rates that avoid frequent and significant changes, as described above. Given the size of the potential problem of high augmentation costs, almost any proposal BPA could put forward would have rate shock. However, as a result of discussions with rate case parties leading to the Partial Settlement, BPA and the parties agreed to a revision to the LB CRAC, which would create biannual rate level changes to deal with these augmentation costs. As a result of this, BPA will rely less on contingent measures. We believe that by having an LB CRAC which more closely matches our revenues to our augmentation costs, our proposal will still result in a rate design that results in the overall lowest expected value cost to ratepayers, while achieving our given TPP objectives.

Q. You maintained BPA had not changed its cost recovery goal of 88 percent TPP in the Amended Rate Proposal. Is this also true for this Supplemental Proposal?

A. Yes. BPA's goal continues to be an 88 percent probability that payments to Treasury be made on time and in full over the five-year rate period. *See* Volume 1 of Documentation for Revenue Requirement Study, WP-02-FS-BPA-02A, and the May Record of Decision (May ROD), at 7-7 through 7-10. As in the May and Amended Proposals, this

Supplemental Proposal continues to implement the Fish and Wildlife Principles in order to deal prudently with potential fish mitigation costs. The TPP in the Amended Proposal was 83.4 percent TPP. The range of TPPs for this Supplemental Proposal is from 82.7 percent to 85.9 percent, assuming that BPA's total Slice sales are 2,000 average megawatts (aMW). *See* Lefler, *et al*., WP-02-E-BPA-73.

Q. *Why are you showing a range of TPP values instead of a single number?*

A. We are describing the Supplemental Proposal through the use of a set of analyses instead of a single analysis because of the design of the LB CRAC. The LB CRAC in this Proposal is a formula, rather than a percentage to be fixed in the Final Record of Decision (Final ROD). The formula is based on BPA's net cost of augmentation, which depends on the remaining augmentation need (*i.e.*, the augmentation need for which BPA does not have purchases in place), and a market-based forward indicator of future power prices. As we have noted above, in today's electricity world, future power prices can be highly volatile. In addition, the LB CRAC percentage may be large enough to induce some customers to reduce their BPA load. To avoid basing another proposal on a single estimate of forward prices and remaining augmentation, BPA is presenting a proposal developed with its customers in which the LB CRAC will adjust to market prices and BPA's augmentation needs. Since we cannot predict what the forward prices and remaining augmentation needs will be, we are presenting a range of possibilities.

Q. *With a TPP lower than 88 percent, does your proposal still meet the Principles?*

A. Yes. As with the 83.4 percent TPP in the Amended Proposal, the range of TPPs in this Supplemental Proposal falls within the 80 to 88 percent range allowed by Principle No. 3. The LB CRAC fluctuates as actual augmentation costs change, thereby mitigating that market risk. And as with our Amended Proposal, this proposal still includes the SN CRAC, which serves as additional assurance that payments to Treasury will be made, though it is not modeled in the TPP analysis.

In addition, this proposal yields expected values of ending reserves in FY 2006 of over $1 billion, even after taking into account the effect of the DDC, a result that BPA's May Proposal could not quantify. In the May Proposal, the likelihood that BPA would end 2006 with at least $500 million in reserves was approximately 75 percent. Now, the corresponding range of probabilities is approximately 78 to 85 percent (assuming 2,000 aMW of Slice sales). (*See* Lefler, *et al.*, WP-02-E-BPA-73).

Section 4. Summary of Major Changes in Supplemental Proposal

Q. What are the major changes in this Supplemental Proposal?

A. Consistent with the Partial Settlement Agreement, there are several changes reflected in this Supplemental Proposal. First, design changes are being proposed to each of the three CRACs, in particular the LB and FB CRACs. Second, there are changes to the threshold and other criteria for the DDC mechanism. Third, modifications are being proposed to the calculation of the financial portion of the Investor-Owned Utilities Residential Exchange Program Settlement (REP Settlement). Fourth, modifications are being proposed to the Slice "inventory solution" true-up costs. There are no changes being proposed to the calculations of the Direct Service Industry (DSI) rates, besides those mentioned later in this testimony.

Q. Please summarize the major changes to the three CRAC mechanisms.

A. This Supplemental Proposal retains the three-component CRAC structure (*i.e.*, LB CRAC, FB CRAC, and SN CRAC) that was the center of the Amended Proposal. However, BPA is proposing to modify each of them somewhat, to match the Partial Settlement Agreement.

We are proposing two major changes to the LB CRAC. First, going into successive six-month periods, the value of the LB CRAC will be based on a forecast of augmentation costs, (both market price and augmentation amounts). That forecast would be "trued-up" every six months, after-the-fact, based on actual augmentation costs and revised cost projections. Second, the preliminary LB CRAC amount, set in the final rate proposal, will be shaped to reflect the declining market forecasts. *See* Lefler, *et al*., WP-02-E-BPA-73. As mentioned above, BPA's current forecasts are that market prices would be high in the first year of the rate period and decline by the last year of the rate period. *See* Conger, *et al.*, WP-02-E-BPA-71. The changes to the LB CRAC mean that it will be the primary risk mitigation tool dealing with one of our largest risks, BPA's augmentation costs.

The FB CRAC has reverted back to the May Proposal with two exceptions. First, in the first year the threshold amount has been lowered to Accumulated Net Revenues equal to $300 million in reserves and there is no cap on revenue increases other than this lower threshold. Second, if the FB CRAC triggers, it would be in effect for 12 months. It would be based on a third quarter forecast, and then be trued-up based on audited actuals when those actuals become available a few months later. *See* Lefler, *et al*., WP-02-E-BPA-73.

The SN CRAC was revised so that it could trigger if there is a 50 percent probability of BPA missing a payment to the Treasury, <u>or</u> other creditor; or, alternatively, if BPA misses a payment to <u>either</u> the Treasury or other creditor. Second, in the Amended Proposal, BPA had proposed a public process, short of a 7(i) process, to implement the SN CRAC. This Supplemental Proposal, consistent with the Partial Settlement Agreement, proposes that BPA would conduct a 7(i) and seek FERC approval prior to the SN CRAC being implemented.

Q. *What changes are being proposed to the DDC?*

A. BPA is proposing three modifications to the DDC. First, beginning with the second year of the rate period, if a specific DDC threshold is met, all of the DDC amount (above the $15 million already committed to conservation and renewable resources) will automatically be distributed to customers and will no longer be discretionary on the part of the Administrator. Distributions will no longer be divided and allocated based on decisions in a later public process. Second, the thresholds will be fixed at $1.7 billion in reserves for the second year, $1.5 billion for the third year, and $1.2 billion for each of the last two years. These thresholds will be fixed, except in the event that BPA has outstanding expenses under the Biological Opinion. *See* Lefler, *et al*., WP-02-E-BPA-73. Finally, as part of the Partial Settlement Agreement, BPA is proposing that the Financial portion of the REP Settlement Benefits be eligible for a portion of the DDC. *See* Lefler, *et al*., WP-02-E-BPA-73.

Q. In the Partial Settlement Agreement, are there any other proposed changes to the Investor-Owned Utilities Residential Exchange Program Settlement?

A. Yes. In the Amended Proposal, BPA proposed a $34.1/MWh forecast for purposes of calculating the financial benefits under the REP Settlement. BPA now proposes an adjustment to this number.

Q. What is this adjustment?

A. As noted previously, BPA recently conducted settlement discussions with all interested parties in BPA's WP-02 rate case. As mentioned above, large number of those parties proposed a partial settlement of many rate case issues. One element of that proposal is that $38/MWh should be used in calculating the financial benefits under the REP Settlement, instead of the $34.1/MWh forecast in BPA's Amended Proposal. (BPA's testimony regarding the $34.1/MWh forecast is contained in the testimony of Doubleday, *et al*., WP-02-E-BPA-65, and Doubleday, *et al*., WP-02-E-BPA-74.) Where so many parties support $38/MWh as part of the Partial Settlement Agreement, this suggests that such parties believe that the $38/MWh is consistent with BPA's policy goal of "[s]preading[ing] the benefits of the Federal Columbia River Power System as broadly as possible, with special attention given to the residential and rural customers of the region." *See* Power Subscription Strategy, at 3.

When viewed in the context of the Partial Settlement Agreement, BPA believes that it is appropriate to adjust the forward five-year market forecast from $34.1/MWh to $38/MWh. BPA's $34.1/MWh forecast was developed at a time when market prices had increased significantly from market prices at the time of BPA's May Proposal. However, as noted in the testimony of Conger, *et al.*, WP-02-E-BPA-71, market prices have also increased significantly from the time of BPA's Amended Proposal. BPA has elected to make the adjustment to $38/MWh to reflect this observed price increase in the marketplace because this is consistent with BPA's policy goals as noted above. While BPA does not expect current prices to continue for the five-year period of the forward flat block forecast, BPA feels that current high market prices lasting through the first 6-18 months of the forecast period, viewed in the context of the Partial Settlement Agreement, justify an increase in the forward five-year market forecast price to $38/MWh.

Q. Is BPA proposing changes to the Slice methodology?

A. Yes. The Amended Proposal contained a mechanism to calculate the Slice purchasers' share of BPA's actual augmentation costs. Consistent with the Partial Settlement Agreement, BPA is revising the manner in which Slice purchasers will pay their proportionate share of augmentation costs.

Q. How will Slice purchases pay for their proportionate share of the augmentation costs?

A. BPA is now proposing that the Slice purchasers pay for augmentation in a fashion similar to the manner in which the LB CRAC is now being implemented (*see* Lefler, *et al.*, WP-02-E-BPA-73), with some minor changes in the design of the true-up due to the different nature of the product. (*See* Procter, *et al.*, WP-02-E-BPA-72).

Q. Are Slice purchasers now subject to the LB CRAC?

A. Yes. As a result of the agreements reached in the Partial Settlement Agreement, the manner in which Slice customers pay for their share of augmentation will mirror in almost all respects the design of the LB CRAC. Therefore, the Slice will now be subject to the LB CRAC, with some slight modifications. The LB CRAC adjustment will replace the previous method for the one-time megawatt (MW) true-up and the true-up for actual costs of augmentation. Slice will also continue to be exempt from the FB CRAC and the SN CRAC since the risks that those CRACs are designed to cover are already directly assumed by the Slice Customers. (*See* Lefler, *et al*., WP-02-E-BPA-73). Slice continues to not be eligible for the DDC.

Q. Are there any proposed changes to the rates to be charged the DSIs?

A. No. The Industrial Firm Power Targeted Adjustment Charge rate will remain unchanged. The LB CRAC, FB CRAC, and SN CRAC will all apply to the DSI rates. And the DSIs will be eligible for the DDC. Of course, the CRACs are modified from the Amended Proposal, as described elsewhere in this testimony.

Q. Are there any other significant changes that are being made in this Supplemental Proposal?

A. Yes. As we mentioned above, BPA has noticed that market prices during the rate period are appearing to be significantly higher than our models would indicate in the first years of the rate period. In the testimony of Conger, *et al.*, WP-02-E-BPA-71, we describe the steps we have taken to calibrate our models to more closely match the observed market price levels.

Q. What updates does BPA intend to include in the final proposal?

A. Each piece of technical testimony identifies the particular information that would be updated. However, in particular, the augmentation cost inputs into the LB CRAC formula will be updated and shown in the final studies. BPA understands that given our current expectations of those augmentation costs, based on the amount of power we will need to purchase and the prices at which we may have to make these purchases, the LB CRAC formula has the potential of resulting in a very large rate increase, particularly in the early part of the rate period. BPA understands the harmful impact that these large rate increases could have on the region. Therefore, we are committed to work to lower those augmentation costs including conservation efforts. We will work with customers to reduce the amount of augmentation purchases we must make. We will also work diligently to manage the purchases we must make, in order to get the best price we can.

In addition, if BPA is able to resolve cash flow issues, it may be able to restructure the LB CRAC to produce average LB CRAC increases, that is, a LB CRAC percentage that recovers the net augmentation costs for more than one year over a period of the same number of years. For example, there could be a single LB CRAC percentage for a two-year period that recovers BPA's net augmentation costs for that two-year period, with a true-up following.

Q. *Does this conclude your testimony?*

A. Yes.

ATTACHMENT A

PARTIAL STIPULATION E: SETTLEMENT AGREEMENT

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